Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:KSM:KCY:TL-N-6943-98
MLBoman

date: MAY 0 6 1999

to: Chief, Examination Division, Kansas-Missouri District
Attention: Edith Cartmill

from: Associate District Counsel, Kansas-Missouri District, Kansas City

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subject: **Informal Evaluation of Suit to Recover Erroneous Refunds**

This supplements our prior written advice and confirms our telephone conversation with Edith Cartmill.

Our prior memorandum suggested further factual development. That memorandum has been post-reviewed by our National Office. They agreed with our recommendation for further factual development on the claims that were erroneously allowed, but stressed the general rule that payments made to departing employees are wages subject to employment taxes.

You have advised us that you have determined to discontinue the erroneous refund cases, but that you are considering other claims filed by subsidiaries of the taxpayers. Our advice on the erroneous refund cases must be interpreted in light of two salient facts: (1) The pronouncements of Rev. Rul. 93-88, since revoked, but only prospectively; and (2) the burden of proof in an erroneous refund suit on the government to affirmatively prove that the payments are <u>not</u> excludible. Outside the context of the erroneous refund suit, the burden of proof is on the taxpayer to show that it is outside the general rule of taxability.

For your benefit, we are including here some comments by EBEO:

> Federal Insurance Contributions Act (FICA) taxes are imposed on "wages" as that term is defined in section 3121(a). Section 3121(a) provides that the term "wages" means "all remuneration for employment," with exceptions not relevant here. The term "employment" is defined for FICA purposes in section 3121(b) as any service of whatever nature, performed by an employee for the person employing him, again with exceptions not applicable here.

Section 31.3121(a)-1(c) of the Employment Tax Regulations provides that the name by which the remuneration for employment is designated is immaterial in determining whether payments are wages. Section 31.3121(a)-1(d) of the regulations provides that the basis upon which the remuneration is paid is generally immaterial. Section 31.3121(a)-1(h) of the regulations provides that remuneration for employment, unless such remuneration is otherwise excluded, constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them.

In determining the tax treatment of damages received from a lawsuit or in settlement of a lawsuit, one looks to the nature of the item for which the damages are a substitute. Therefore, amounts received in lieu of remuneration for employment are treated as wages for employment tax purposes, unless an exception applies.

Whether an amount received in settlement is in lieu of remuneration for employment depends on the nature of the claim which served as the basis for the settlement, and such determination is a factual one.

The definitions of "wages" and "employment" used in the FICA originated in the Social Security Act of 1935, Pub. L. No. 74-271, section 210, and have been retained essentially unchanged. In Social Security Board v. Nierotko, 327 U.S. 358 (1946), the United States Supreme Court held that back pay awarded under the National Labor Relations Act to an employee who had been wrongfully discharged constituted "wages" under the Social Security Act. The Court stressed that the definition of "employment" is broad (id. at 365-66):

> The very words "any service ... performed ... for his employer," with the purpose of the Social Security Act in mind, import breadth of coverage. They admonish us against holding that "service" can be only productive activity. We think "service" as used by Congress in this definitive phrase means not only work actually done but the entire

> employer-employee relationship for which compensation is paid to the employee by the employer.

The legislative history of the FICA tax provisions reflects that amounts paid because of the dismissal of an employee are considered wages subject to the FICA tax. Prior to 1950, the Internal Revenue Code excluded from the definition of wages for FICA tax purposes dismissal payments which the employer was not legally required to make. The exclusion was eliminated in the Social Security Amendments of 1950, ch. 809 (64 Stat. 477). The Committee Reports describe the effect of the change as follows:

> Therefore, a dismissal payment, which is any payment made by an employer on account of involuntary separation of the employee from the service of the employer, will constitute wages, subject, of course, to the $3,600 limitation [$68,400 in 1998], irrespective of whether the employer is, or is not, legally required to make such payment.

H.R. Rep. No. 1300, 81st Cong., 2d Sess. 124 (1950-2 C.B. 255, 277); S. Rep. No. 1669, 81st Cong., 2d Sess. 130 (1950-2 C.B. 302, 336).

The Service has published a number of revenue rulings holding that payments received in settlement of claims under various employee rights statutes are wages for FICA tax purposes. For example, in Rev. Rul. 96-65, 1996-2 C.B. 7, the Service held, in part, that back pay received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII of the Civil Rights Act of 1964 is wages for purposes of the FICA. Rev. Rul. 72-572, 1972-2 C.B. 535, holds that an amount paid in settlement of a state law discrimination claim brought by a terminated employee is wages for FICA purposes.

In addition, the Service has published other revenue rulings holding that payments upon the dismissal of an employee are wages for FICA purposes. For example, in Rev. Rul. 73-166, 1973-1 C.B. 411, the Service held that amounts paid to striking employees who were not reemployed after settlement of a strike were subject to

FICA taxes. Also, Rev. Rul. 90-72, 1990-2 C. B. 211, holds that lump sum payments upon the involuntary separation from employment of an employee are wages for FICA tax purposes.

In addition, a number of courts have held that settlements received under various workers' rights statutes are wages for FICA tax purposes. These cases reflect the reasoning in Nierotko (which was quoted above) that "wages" and "employment" should be given broad meanings under the FICA. Courts have held that back pay awards under the Back Pay Act (5 U.S.C. section 5596) are FICA wages. Tanaka v. Department of Navy, 788 F.2d 1552, 1553 (Fed. Cir. 1986); Ainsworth v. United States, 399 F.2d 176, 185-186 (Ct. Cl. 1968); Leverette v. United States, 142 F.Supp. 955, 958-959 (Ct. Cl. 1956). In addition, courts have held that payments received by former employees in settlement of a class action lawsuit against their former employer under the Employee Retirement Income Security Act (ERISA), for allegedly discharging the employees to avoid incurring pension liability, are wages for FICA tax purposes. See, for example, Hemelt v. United States. 122 F.3d 204 (4th Cir. 1997); but see Dotson v. United States, 87 F.3d 682 (5th Cir. 1996).

Summarizing the above information, generally, payments in settlement of claims by a former employee against an employer that the employee was illegally terminated in violation of workers' rights statutes or civil rights statutes are in the nature of dismissal pay and are wages for FICA tax purposes.

No further action is currently required, and we are closing our file. Questions may be directed to Michael L. Boman at (816) 283-3046, extension 107.

(signed) Michael L. Boman

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Senior Attorney

Office of Chief Counsel
Internal Revenue Service

memorandum

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to: Chief, Examination Division, Kansas-Missouri District
Attention: Edith Cartmill, Revenue Agent

from: Associate District Counsel, Kansas-Missouri District, Kansas City

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subject: **Informal Evaluation of Suit to Recover Erroneous Refunds**

This is in response to your memorandum of October 7, 1998, requesting our evaluation of the evidence in this case in light of the government's burden of proof in erroneous refund cases.

The issue in this case is the treatment of payments made to terminated employees. You contend that the payments are severance pay. Taxpayer claims that they are settlements excludable from gross income under I.R.C. § 104(a)(2) and therefore are not wages subject to FICA. It appears that [redacted] had a policy of not granting severance pay, but nevertheless in many instances made some payments taking in most cases a release of claims.

Although you have claims for numerous [redacted] entities under examination, the Service Center has allowed claims for [redacted] for the following three [redacted] entities.

[redacted] $[redacted]

The evidence gathered to date includes the "settlement agreements" executed by some, but not all, of the terminated employees, as well as some correspondence relating to litigation of some employees of other entities.

The correspondence, which as noted does not specifically apply to the three entities under consideration, included claims for age discrimination, national origin discrimination, disability discrimination, and race discrimination. A claim might include more than one allegation, e.g., both age and national origin.

The settlement agreements take various forms.

1. The typical agreement is a four paragraph document captioned "Release and Severance Agreement". The first paragraph provides:

> In consideration of payment of the sum of [redacted], I, [redacted] do hereby release and forever discharge [redacted], its subsidiaries, affiliated companies, officers, directors, agents and employees (hereafter referred to as "[redacted]") of all claims, demands, rights and causes of action that I may have arising out of my employment with [redacted] or the termination of such employment. This release specifically includes, but is not limited to, any and all claims, demands, rights and cause of action arising under Title VII of the Civil Rights Act of 1964, the Civil Rights Act of 1991, the Age Discrimination in Employment Act, the Americans with Disabilities Act and any similar state laws.

2. Some of the agreements omit the fourth paragraph which set forth time limits to consider the agreement as well as a seven day revocation period after the signing of the agreement.

3. At least one of the agreements ([redacted]) requires payment to the individual and his attorney. The [redacted] agreement also provides in part:

> I understand and agree that such payments are made for tort and tort-like claims and personal injury within the meaning of Section 104(A) of the Internal Revenue Code. I also understand and agree that such payments are not subject to income tax withholding or other assessment.

4. At least one of the agreements ([redacted]) has an agreement that the former employee will refrain from entering upon [redacted] property.

5. Another form of agreement is the "Release and Confidentiality Agreement". In these cases the termination date is agreed upon in advance and the payment is denoted as "severance pay". The agreement however contains terms of release similar to the first agreement.

6. Some of the employees also signed "Consultation Agreements". In the case of [redacted] taxpayer wants to exclude the "severance pay", but has apparently not excluded the pay for consulting services.

7. In the case of [redacted] who signed a "Release and Confidentiality Agreement" the taxpayer claims a settlement payment of $[redacted]. The agreement however required "severance pay" of $[redacted], a "social security supplement" of $[redacted] to be paid over [redacted] months, and a "retirement supplement".

8. [redacted] signed a "Early Retirement and Consultation Agreement". The agreement required payments of $[redacted] per month for consulting services. Unlike the case of [redacted] the taxpayer excluded the consulting fees as a settlement payment.

8. [redacted] signed a document caption "Release" releasing "all claims, demands, rights and causes of action that I may have arising out of any and all personal property claims, damage to my personal property and any claims arising out of my employment with [redacted]".

We suspect that a large portion of the payments relate to potential liabilities for alleged age discrimination. Such payments would not be excludable under I.R.C. § 104(a)(2). See Commissioner v. Schleier, 515 U.S. 323 (1995). The problem with the case at this point is that we simply do not know what claims the taxpayer was intending to settle. Unless it can be said as a matter of law that the former employees could not have had claims for excludable damages, then we cannot meet our burden of proof.

In Rev. Rul. 93-88, 93-2 C.B. 61, the Service ruled on the excludability of various payments in settlement of claims. The Service's ruling included the following:

> (1) Compensatory damages, including back pay, received in satisfaction of a claim of disparate treatment gender discrimination under Title VII of the Civil Rights Act of 1964, as amended in 1991, are excludable from gross income as damages for personal injury under section 104(a)(2) of the Code. This is true even if the compensatory damages in such a case are limited to back pay.
>
> (2) Compensatory damages, including back pay, received in satisfaction of a claim of racial discrimination under 42 U.S.C. § 1981 and Title VII of the Civil Rights Act of 1964 are excludable from gross income as damages for personal injury under section 104(a)(2) of the Code. This is true even if the compensatory damages in such a case are limited to back pay.

(3) Similar results will apply to amounts received under the Americans With Disabilities Act.

Rev. Rul 96-65, 96-2 C.B. 6, declared Rev. Rul. 93-88 obsolete. Rev. Rul. 96-65 severely limited the amounts of damages that could be excluded, although it did leave excludable damages received for emotional distress as a result of disparate treatment employment discrimination. More importantly, the Revenue Ruling operated prospectively only as of June 14, 1995. Thus, the taxpayer in this case may rely upon Rev. Rul. 93-88 for the [redacted] taxable year.

Since federal law, as applicable to [redacted], provided for damages excludable under section 104(a)(2), we cannot say as a matter of law that the settlements could not have been excludable. We have not considered the various state law remedies.

As we have noted, the government has the burden of proof in an erroneous refund suit. The record in this case would not support a prima facie case that the payments were not excludable. Absent further factual development, we would not recommend suit in this case.

You might consider issuing summonses in the case. If the taxpayer chooses not to fully comply, however, there is a substantial likelihood that we could not enforce compliance soon enough for a timely referral of the erroneous refund suit to the Department of Justice. Nevertheless, if you choose to issue summonses, we will be happy to assist you in preparing them.

No further action is currently required, and we are closing our file. Questions may be directed to Michael L. Boman at (816) 283-3046, extension 107.

JAMES E. CANNON
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By: (signed) Michael L. Boman
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